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**FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY**

Margalie Roman Salas  
Secretary  
Federal Communications Commission  
445 12<sup>th</sup> Street, SW  
Room TW – A325  
Washington, DC 20554

Dear Ms. Salas:

Re: **CC Docket No. 98-166**

Rebuttal Filing of the United States Telephone Association, National Telephone Cooperative Association, National Rural Telecom Association, Organization for the Promotion and Advancement of Small Telecommunications Companies, Independent Telephone and Telecommunications Alliance, and National Exchange Carrier Association

Attached is the Joint Rebuttal Case filing of the above-referenced ILEC trade associations. Should you have any questions regarding this filing, please contact the undersigned counsel.

Sincerely,

A handwritten signature in black ink, appearing to read "Keith Townsend".

Keith Townsend  
Director Legal & Regulatory Affairs  
& Senior Counsel

cc: Hon. William E. Kennard  
Hon. Susan Ness  
Hon. Michael K. Powell  
Hon. Harold Furchtgott-Roth  
Hon. Gloria Tristani  
Lawrence Strickling  
Lisa Zaina

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Before the  
**Federal Communications Commission**  
Washington, D.C. 20554

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**APR 08 1999**

**FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY**

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In the Matter of )  
)  
)

Prescribing the Authorized )  
Unitary Rate of Return for Interstate )  
Services of Local Exchange Carriers )  
\_\_\_\_\_ )

CC Docket No. 98-166

**JOINT REBUTTAL SUBMISSION  
OF LOCAL EXCHANGE CARRIER ASSOCIATIONS**

**FILING ASSOCIATIONS:**

United States Telephone Association

National Telephone Cooperative Association

National Rural Telecom Association

Organization for the Promotion and  
Advancement of Small Telecommunications  
Companies

Independent Telephone and Telecommunications  
Alliance

National Exchange Carrier Association

April 8, 1999

## SUMMARY

The responsive submissions in this proceeding show that, rather than altering the authorized rate of return, the Commission first should address other items, such as universal service, interconnection, access, and separations issues, that are more important to carriers and customers alike.

As the Associations' response demonstrates, if the Commission proceeds with a represcription, the authorized rate of return should be raised to reflect the incumbent LECs' current cost of capital of between 13.95% and 14.15%. The Associations' estimate of this cost of capital is based on a market-value capital structure for the average incumbent LEC. The analysis conservatively applies a discounted cash flow model for a group of publicly traded firms comparable in risk to the average incumbent LEC, a capital asset pricing model analysis for that comparable group of firms, and is corroborated through a risk premium analysis based on capital market expectations.

The attached rebuttal testimony of Drs. Avera and Billingsley show that the analyses of parties that seek to lower the authorized rate of return are wrong and should be disregarded. Like the proposals of GSA and MCI WorldCom in their initial submissions, AT&T's proposal is so unrealistic and so far below the incumbent LECs' capital costs that, if adopted, it would be confiscatory under the Fifth Amendment to the U.S. Constitution.

Among other things, AT&T and its affiants incorrectly rely on a capital structure for the LECs based on book values. AT&T's analysis dramatically understates the incumbent LECs' cost of equity, and errs in calculating the cost of debt. GSA also wrongly attacks the use of a market value capital structure. MCI WorldCom's contentions are fundamentally flawed as well.

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Before the  
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Prescribing the Authorized ) CC Docket No. 98-166  
Unitary Rate of Return for Interstate )  
Services of Local Exchange Carriers )  
\_\_\_\_\_)

JOINT REBUTTAL SUBMISSION  
OF LOCAL EXCHANGE CARRIER ASSOCIATIONS

I. INTRODUCTION

The Local Exchange Carrier Associations (the "Associations")<sup>1/</sup> hereby file their joint rebuttal submission in the above-captioned prescription proceeding.<sup>2/</sup> The responses filed in this proceeding reinforce the Associations' position that, rather than altering the authorized rate of return, the Commission first should address other items, such as universal service, interconnection, access, and separations issues, more important to carriers and

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<sup>1/</sup> The Associations are the United States Telephone Association ("USTA"), the National Telephone Cooperative Association ("NTCA"), the National Rural Telecom Association ("NRTA"), the Organization for the Promotion and Advancement of Small Telecommunications Companies ("OPASTCO"), the Independent Telephone and Telecommunications Alliance ("ITTA"), and the National Exchange Carrier Association ("NECA").

<sup>2/</sup> See 47 C.F.R. §§ 65.103-105. This filing rebuts responsive submissions and replies filed on March 16, 1999, with respect to paragraphs 1 through 50 of the above-captioned Notice Initiating a Prescription Proceeding and Notice of Proposed Rulemaking, FCC 98-222 (rel. Oct. 5, 1998) (the "Notice"). Where indicated, this filing also addresses replies filed on March 16, 1999 to initial comments on the rulemaking proposals in paragraphs 51 through 55 of the Notice. All references in this rebuttal submission to the "response" of a party refer to a responsive submission or reply comments filed on or about March 16, 1999 in CC Docket No. 98-166.

customers alike.<sup>3/</sup> To act in this proceeding before the public and the financial markets can respond to the results of the Commission's multiple pending proceedings on such issues would be extremely premature.

As the Associations demonstrated in their response, if the Commission were to perform a represcription, the authorized rate of return should be increased to reflect the incumbent LECs' current cost of capital, which is between 13.95% and 14.15%.<sup>4/</sup> The Associations' analysis properly is based on a market-value capital structure for the average incumbent LEC. The analysis conservatively applies a discounted cash flow ("DCF") model for a group of publicly traded firms comparable in risk to the average incumbent LEC, a capital asset pricing model ("CAPM") analysis for that comparable group of firms, and is corroborated through a risk premium analysis based on capital market expectations.

The attached rebuttal testimony of Dr. William E. Avera and Dr. Randall S. Billingsley<sup>5/</sup> show that the analyses of parties that seek to lower the authorized rate of return are wrong and should be disregarded.<sup>6/</sup> For example, AT&T's analysis incorrectly relies on a capital structure for the LECs based on book values. It dramatically understates the incumbent LECs' cost of equity, and errs in calculating the cost of debt.<sup>7/</sup> GSA similarly

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<sup>3/</sup> See response of the Associations at 3-4; SBC Communications Inc. ("SBC") at 1, 6; Bell Atlantic at 2, 9; U S West, Inc. ("U S West") at 3-5.

<sup>4/</sup> See response of the Associations at 3, 6-8.

<sup>5/</sup> See Attachment A hereto ("Avera rebuttal"); Attachment B ("Billingsley rebuttal").

<sup>6/</sup> See *especially* response of AT&T Corp. ("AT&T"); General Services Administration ("GSA"); MCI WorldCom, Inc. ("MCI WorldCom").

<sup>7/</sup> See Avera rebuttal at 1-5; Billingsley rebuttal at 2-3, 4-21.

and wrongly attacks the use of a market value capital structure.<sup>8/</sup> MCI WorldCom's contentions are similarly flawed.<sup>9/</sup>

## II. THE HIGH RISKS FACED BY INCUMBENT LECS ARE REFLECTED IN THEIR INCREASING COST OF CAPITAL

As the Associations have demonstrated, and contrary to the claims of AT&T, GSA, and MCI WorldCom, the capital costs of incumbent LECs are increasing because they reflect the substantial risks posed by regulatory uncertainty, the continued growth of competition, and technological change in the telecommunications industry. The present authorized interstate rate of return of 11.25% is low based on the magnitude of these risks. Dr. Billingsley's 13.95% to 14.15% estimate of the incumbent LECs' cost of capital is a quantification of the high risks faced by incumbent LECs. It also highlights the conservative nature of the present authorized rate of return. This estimate properly uses market values, rather than book or historical values, to determine the LECs' average capital structure, cost of equity, and cost of debt.

Some parties argue that the Commission should base a prescription on historical data, rather than market-based data.<sup>10/</sup> As Dr. Billingsley has shown, the only relevant measure of the cost of capital is the expected cost of capital based on market values.<sup>11/</sup> Past rate-of-return proceedings relied on historical data on the assumption that LECs were operating in

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<sup>8/</sup> See *id.* at 4, 22-23.

<sup>9/</sup> See *id.* at 4, 21-22.

<sup>10/</sup> See, e.g., response of MCI at 6, 12-15.

<sup>11/</sup> See Billingsley testimony, attached to response of the Associations, at 34.

a stable, franchise monopoly environment. However, given the sweeping legal and industry changes due to the Telecommunications Act of 1996 (the "1996 Act"), measures of past performance and capital structure cannot be used to estimate prospective capital costs. Only a market-based analysis, including a market-based capital structure, can properly estimate incumbent LECs' risks so as to produce a fair and reasonable rate of return as required by law.<sup>12/</sup>

*Regulatory Risks:* The regulatory risks to LECs and their customers from implementation of the 1996 Act continue to increase.<sup>13/</sup> As the Associations have noted, several of the Commission's implementation decisions restrict the ability of incumbent LECs to recover their reasonable costs of providing service. Regarding interconnection, unbundling, and reciprocal compensation issues,<sup>14/</sup> uncertainties have increased in 1999 with respect to compensation arrangements.<sup>15/</sup> This is especially the case for Internet

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<sup>12/</sup> See, e.g., *Bluefield Water Works & Improvements Co. v. Pub. Serv. Comm'n of West Virginia*, 262 U.S. 679, 692-693 (1923). As the Supreme Court later held:

...it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock...By that standard the return to the equity owner should be commensurate with risks on investments in other enterprises having corresponding risks. That return, moreover, should be adequate to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

*Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) ("*Hope*").

<sup>13/</sup> See Billingsley rebuttal at 19-20.

<sup>14/</sup> See *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 FCC Rcd 15499 (1996), *aff'd in part, remanded in part*, *AT&T Corporation v. Iowa Utilities Board*, 1999 U.S. Lexis 903 (Nos. 97-286, *et al.* Jan. 25, 1999).

<sup>15/</sup> The incremental pricing methodologies that the Commission has adopted in its proceedings on reciprocal compensation and unbundling, *see supra*, may result in pricing  
(continued...)



traffic, because, although the Commission recently ruled that Internet-bound calls are jurisdictionally interstate, uncertainty persists as to the mechanisms for separations and inter-carrier compensation related to such traffic.<sup>16/</sup>

The ongoing overhaul of the Commission's universal service and access charge systems pose similar risks for reasonable cost recovery by incumbent LECs.<sup>17/</sup> Most starkly, the Commission has not defined the size or structure of universal service support. It remains unclear whether universal service support for rural LECs will be reduced if these LECs are subjected to the new proxy models that the Commission is creating. Although AT&T apparently assumes that the forthcoming universal service system "should address any legitimate concerns"<sup>18/</sup> regarding the costs and quality of service to rural customers, this assumption is by no means a certainty, and such uncertainty has increased risks for incumbent LECs.<sup>19/</sup> Interstate access revenues are also uncertain, as the Commission

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<sup>15/</sup>(...continued)

below fully distributed cost. Such proceedings are a primary source of risk for incumbent LECs because investors may conclude that such pricing rules may not permit adequate cost recovery. These issues cannot be addressed until the effects of the proceedings are known.

<sup>16/</sup> See *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Inter-Carrier Compensation for ISPs*, CC Docket Nos. 96-98, 99-68, Declaratory Ruling and Notice of Proposed Rulemaking, FCC 99-88 (rel. Feb. 26, 1999).

<sup>17/</sup> See, e.g., *Federal-State Joint Board on Universal Service*, 12 FCC Rcd 8776 (1997), appeal pending sub nom. *Texas Office of Public Utility Counsel v. FCC*, No. 97-60421 (5th Cir. argued Dec. 1, 1998); *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Second Recommended Decision, FCC 98J-7 (rel. Nov. 25, 1998). See also *Access Charge Reform*, First Report and Order, 12 FCC Rcd 15982 (1997); Order on Reconsideration, 12 FCC Rcd 10119 (1997); *aff'd sub nom. Southwestern Bell Telephone Co. v. FCC*, 153 F.2d 523 (8th Cir. 1998); Second Order on Reconsideration, 12 FCC Rcd 16606 (1997).

<sup>18/</sup> See response of AT&T at 28 n. 78.

<sup>19/</sup> See Avera rebuttal at 5.

considers major changes to the access rate structure for small and midsize rate-of-return LECs. The Commission should resolve such crucial issues before any represcription.<sup>20/</sup>

In addition, LECs have become subject to major new regulatory obligations under the 1996 Act, often with no assurance that they will be able to recover the accompanying costs that must be incurred.<sup>21/</sup> Other pending proceedings also increase regulatory risks.<sup>22/</sup> Among other things, the Commission is in the process of changing the jurisdictional separations rules<sup>23/</sup> and revising the Uniform System of Accounts.<sup>24/</sup>

*Competitive Risks:* Competition for incumbent LECs' interstate services is growing rapidly. Although AT&T and MCI WorldCom attempt to minimize the effects of such competition on incumbent LECs, they and other interexchange carriers ("IXCs") are vying for incumbent LECs' most attractive business customers. In doing so, those IXCs provide

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<sup>20/</sup> Statutory provisions such as the exemptions and suspensions of section 251(f) of the Act do not lessen the regulatory risks for rate-of-return LECs. An ongoing regulatory uncertainty for affected LECs is the potential cost of compliance with interconnection and other requirements when the provisions of section 251(f) no longer apply.

<sup>21/</sup> Examples include local number portability obligations, consumer proprietary network information protection requirements, and the cost of new regulations under the Communications Assistance for Law Enforcement Act.

<sup>22/</sup> Nor has the Commission resolved multiple biennial review and forbearance proceedings involving accounting, depreciation, and reporting rules. *See, e.g., 1998 Biennial Regulatory Review -- Review of Accounting and Cost Allocation Requirements; United States Telephone Association Petition for Rulemaking*, CC Docket No. 98-81, ASD File No. 98-64, Notice of Proposed Rulemaking, FCC 98-108 (rel. June 17, 1998).

<sup>23/</sup> *See Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, Notice of Proposed Rulemaking, 12 FCC Rcd 22120 (1997).

<sup>24/</sup> Those LECs that have drawn a large share of their revenues from interstate access cannot predict whether separations changes will be made that will shift additional costs to the intrastate jurisdiction for recovery in local rates from their small customer bases. *See Amendments to Uniform System of Accounts for Interconnection*, CC Docket No. 97-212, Notice of Proposed Rulemaking, FCC 97-355 (rel. Oct. 7, 1997).

no benefit to most residential customers. At the same time, IXCs attempt to use the regulatory process, rather than competitive entry, to reduce all access prices. These tactics increase the risks of all incumbent LECs, especially the many rate-of-return LECs in rural areas that serve only a few business customers.

*Technology Risks:* Technological development is increasing the risks faced by incumbent LECs, especially in the case of rate-of-return LECs that cannot readily update their infrastructures due to regulatory controls. Incumbent LECs must adjust to new technologies and applications, including Internet telephony, satellite communications, terrestrial wireless communications such as Fixed Wireless Access, and the use of cable modems and other broadband applications. These technological developments place great pressure on incumbent LECs to obtain the capital needed to prevent obsolescence,<sup>25/</sup> even as these LECs are addressing Y2K issues critical to all users. As a whole, the increasingly risky regulatory, competitive, and technological environment results in a cost of capital far in excess of the current prescribed rate of return.

### III. THE COMMISSION SHOULD REJECT PROPOSALS TO DECREASE THE PRESCRIBED RATE OF RETURN

As Dr. Avera and Dr. Billingsley describe in detail, the attempts of AT&T, GSA, and MCI WorldCom to justify a lower authorized interstate rate of return are fallacious.<sup>26/</sup>

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<sup>25/</sup> See Billingsley rebuttal at 20.

<sup>26/</sup> See Avera rebuttal; Billingsley rebuttal at 2-23.

*AT&T*: The analysis proffered by AT&T to support its proposal that the rate of return be lowered to within a range from 8% to 9%<sup>27/</sup> is full of errors and internal inconsistencies that render it useless. Like the proposals of GSA and MCI WorldCom in their initial submissions in this docket, AT&T's proposal is so unrealistic and so far below the cost of capital of the incumbent LECs that, if adopted by the Commission, it would be confiscatory under the Fifth Amendment to the U.S. Constitution.<sup>28/</sup>

AT&T and its affiants, Dr. Cornell and Mr. Hirshleifer, incorrectly rely on book values, rather than market valuation, to estimate incumbent LEC capital structures.<sup>29/</sup> As Dr. Billingsley explains, in their DCF analysis of the cost of equity, AT&T and its affiants use an error-filled, subjective three-stage model and growth rate forecasts that do not comport with the reality of investors' expectations.<sup>30/</sup> AT&T and its affiants also incorrectly define the Regional Bell Holding Companies ("RBHCs"), GTE, and certain other telephone companies as being representative in terms of risk of the incumbent LECs in general.<sup>31/</sup> There is no empirical basis for this assumption.<sup>32/</sup>

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<sup>27/</sup> See response of AT&T at iv, 31.

<sup>28/</sup> See, e.g., *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 310 (1989), quoting *Hope*, *supra*, 320 U.S. at 605 (utility must be allowed to "maintain its financial integrity, to attract capital, and to compensate its investors for the risk assumed").

<sup>29/</sup> See Avera rebuttal at 2-3; Billingsley rebuttal at 4-7.

<sup>30/</sup> See *id.* at 7-14.

<sup>31/</sup> See *id.* at 14-15.

<sup>32/</sup> At the same time, AT&T's DCF estimates do not properly adjust for flotation costs and the quarterly payment of dividends. See Billingsley rebuttal at 15-16.

With respect to CAPM analysis, AT&T and its affiants substantially underestimate the cost of equity.<sup>33/</sup> AT&T does so by relying on its faulty three-part model and historical market data from time periods -- extending well into the last century -- that are completely irrelevant to present market conditions.

In estimating the cost of debt, AT&T again improperly relies on book value, rather than market-based, data. It also wrongly bases its estimates on (i) shorter-term debt that incumbent LECs would not use to finance typical investments and (ii) stale market data.<sup>34/</sup>

In addition to these logical and methodological failures, AT&T's proposal wrongly features a "compensating downward adjustment" of 0.5% based on a variety of erroneous assumptions and claims primarily involving the RBHCs.<sup>35/</sup> There is no basis for such an adjustment. Even if these factors were accurate, which is not so, they focus largely on the RBHCs, which, as Dr. Billingsley has shown, are not representative of the incumbent LECs.

GSA: GSA also incorrectly defends use of regulatory capital structures, rather than the market-based capital structure that Drs. Avera and Billingsley rightly use in estimating the incumbent LECs' capital costs.<sup>36/</sup> Moreover, there is no merit in GSA's claim that in order to avoid a decrease in the authorized rate of return, the incumbent LECs must show that they are having difficulty raising capital.<sup>37/</sup> As Dr. Avera notes, incumbent LECs must be able to raise capital even in adverse market conditions, especially small or rural

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<sup>33/</sup> See *id.* at 16-17.

<sup>34/</sup> See *id.* at 18-19.

<sup>35/</sup> See response of AT&T at 28-31.

<sup>36/</sup> See Billingsley rebuttal at 22-23.

<sup>37/</sup> See response of GSA at 14-15.

LECs, which, like more diversified LECs, continue to have carrier-of-last-resort obligations.<sup>38/</sup>

*MCI WorldCom:* MCI WorldCom incorrectly asserts that the recent general decline in interest rates has been associated with a general decline in the cost of equity for the telecommunications industry.<sup>39/</sup> To the contrary, MCI presents no empirical or other evidence to support this claim. As was demonstrated in the Associations' response, the capital costs of the S&P 500 have increased, not decreased, since 1990.<sup>40/</sup>

Accordingly, the Commission should give no weight to the submissions of AT&T, GSA, or MCI WorldCom.<sup>41/</sup>

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<sup>38/</sup> See Avera rebuttal at 4.

<sup>39/</sup> See response of MCI WorldCom at 7. Dr. Avera notes that his prior testimony in this docket and that of Dr. Billingsley, Dr. Vander Weide, and Mr. Cummings confirm the reasonableness of a higher cost of capital for the incumbent LECs. See Avera rebuttal at 1.

<sup>40/</sup> See Billingsley rebuttal at 21-22, *citing* Exhibit RSB-8, attached to response of the Associations. At the same time, MCI offers no evidence to support its claim that the RBHCs' market returns could not have occurred if their business risk was increasing. See Billingsley rebuttal at 22.

<sup>41/</sup> The Associations have consistently proposed in this proceeding that the low-end formula adjustment mechanism ("LFAM"), a price cap regulatory mechanism, be reviewed in a separate proceeding that considers comprehensively any changes to the price cap regime and the resulting impacts on price-cap LECs and their customers. Changes to LFAM are far more complex than simply an increase or decrease based on a represetion of a rate of return applicable to LECs not subject to price cap regulation.

The issues to be considered are uniquely applicable to the price-cap LECs and are well outside the scope of this proceeding. In their responses, AT&T and GSA raise issues concerning reinstatement of the price cap earnings sharing mechanism, adjustments to the price cap or prices of price-cap LECs based on changes to the prescribed rate of return for rate-of-return LECs, and the calculation of the price cap productivity factor. See, e.g., response of AT&T at 33-35, reply comments of GSA at 2, reply of GSA to direct cases at 16. These latest proposals by AT&T and GSA clearly are not related to the prescription of a unitary rate of return and already have been thoroughly considered and decided in a series of Commission proceedings on price cap issues such as CC Docket No. 94-1, *Price Cap*

(continued...)

#### IV. CONCLUSION

If a represcription takes place, the Commission should increase the incumbent LECs' authorized interstate rate of return substantially, for the reasons described above.

Respectfully submitted,

#### LOCAL EXCHANGE CARRIER ASSOCIATIONS

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April 8, 1999

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<sup>41/</sup>(...continued)

*Performance Review for Local Exchange Carriers*, and CC Docket No. 96-262, *Access Charge Reform*. The Commission therefore should disregard those issues in this proceeding.

**CERTIFICATE OF SERVICE**

I, Sharron V. Turner, do certify that on April 8, 1999 copies of the foregoing Joint Rebuttal Case of the Local Exchange Carrier Associations were either hand-delivered, or deposited in the U.S. Mail, first-class, postage prepaid to the persons on the attached service list.

  
Sharron V. Turner



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